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Statement by

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Supervision, Regulation and Insurance

Committee on Banking, Currency and Housing

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I am pleased to have this opportunity to present the views of the Board of Governors on Title V of the Committee's Discussion Principles -- the part concerned with reorganization of the Federal Reserve System.

Let me, first of all, congratulate this Committee, and Chairman Reuss and St Germain in particular, for the leadership you have shown in undertaking what could become one of the historic studies in the field of regulation of financial institutions. Your Committee's study, Financial Institutions and the Nation's Economy, has focused attention on areas that are of great importance to the economic health of our Nation. We at the Board of Governors stand ready to assist you in any way we can.

I am here to present the Board's views on proposals in your Discussion Principles that call for changes in the structure of the Federal Reserve System. These recommendations are far-reaching and, if adopted by the Congress, would fundamentally alter the character of the Federal Reserve. Consequently, it is important to examine the premises on which these recommendations are based before turning to an evaluation of specific suggestions for change.

The first premise is that the Federal Reserve is essentially a "bankers' bank" whose control rests largely in the hands of financial and industrial interests. The second premise is that the Federal Reserve is not sufficiently "responsive" to the needs of all elements of our society and that the System should be revamped to make it more "responsive."

I take strong issue with these premises. The first reflects a basic misconception of the Federal Reserve. The second, I believe, is simply an argument that there should be more political control over the monetary policy functions of the Federal Reserve. I do not think that such a radical revision of our long-standing concept of the proper status of a central bank would be in the public interest.

It is perfectly true, of course, that the Federal Reserve is, in some of its functions, a "bankers' bank." Indeed, Congress created it for just that reason -- that is, to serve as a source of liquidity for our Nation's banking system and to hold the reserves of member banks. The charge that this relationship results in "control" of the System by bankers, however, is erroneous. This premise appears to be based primarily on the fact that member banks own the stock of the Federal Reserve Banks and

elect two-thirds of the directors of the Reserve Banks. At a later point, I shall address the proposals in the Discussion Principles relating to the ownership of Federal Reserve Bank stock and the election of Reserve Bank directors. For the present, I cannot be more emphatic when I say that the control of the Federal Reserve System resides firmly with the Board of Governors.

The members of the Board, having been appointed by the President and confirmed by the Senate, take with utmost seriousness their responsibility to serve the best interests of the American people. I know it is fashionable to charge Federal regulatory agencies with being "captives" of the industries that they regulate; but people who follow closely the activities of the Federal Reserve Board -- particularly those who are aware of the feelings of members of the banking industry about many actions of the Board -- should know that this charge is not applicable to the Federal Reserve.

The claim that the Federal Reserve is not "responsive" to all segments of American society requires careful analysis. I fear that "responsiveness," as that term is often used, is no more than a euphemism for susceptibility to control. Many who claim the System should be more "responsive" really mean that

the Federal Reserve's judgments on monetary policy should be subject to some measure of political direction exercised in behalf of particular interest groups. Those who hold this view often tend to favor more and easier credit, and are therefore generally opposed to the concept of an independent central bank.

There is a clear distinction, however, between being "responsive" to the demands of special interest groups and being sensitive to the needs of the various elements of our society. The Federal Reserve has been extremely sensitive to the impact its decisions may have on different segments of our society. The Board frequently must make very difficult judgments, however, and it is almost inevitable that our decisions will displease some or at times even many of our people. But this is no reason to initiate fundamental changes in the System. Some of the constructive effects of monetary policy take time to emerge, and it is therefore important to judge monetary policy over a broad time frame. The great virtue of an independent monetary authority is that it is able to make objective and informed judgments about these troublesome matters -- free from the transitory pushes and pulls of the political process.

The Federal Reserve is, of course, a creation of Congress. It is clearly within the power of Congress to alter the legal basis of the Federal Reserve System and, if it so desires, to assume for itself more direct responsibilities for the day-to-day formulation of monetary policy. In considering such changes, however, I believe that members of Congress will want to weigh carefully any action that would impair the objectivity of the Nation's monetary authority and its ability to make the difficult decisions that must be made in formulating monetary policy.

One may differ with the Board's judgments on monetary policy matters, and one may even believe that Congress erred in conferring such independence upon the Federal Reserve. But there should be no misunderstanding about the implication of the Discussion Principles: If Congress now sees fit, after more than 60 years of experience, to abandon the concept of a truly independent central bank, then the Congress itself must be willing to assume both the burden and the responsibility of formulating monetary policy.

The Discussion Principles make several specific charges against the Federal Reserve that are apparently intended to support the basic premise that the System should be more "responsive." It is argued, for example, that monetary policy

is shaped largely in secret. This charge apparently stems from the fact that discussions on monetary policy are held at closed sessions of the Board and the Federal Open Market Committee. But this fact does not mean that the Federal Reserve is unaware of the views and needs of those who are affected by our decisions. During these meetings we consider in detail a broad range of information: the studies by our staff, comments from the Reserve Banks and their boards of directors, data and views submitted for our consideration by members of the Congress and other government officials, opinions expressed by academicians, journalists, and representatives of various segments of the public -- all these are taken into account by members of the Board. Because of the sensitive nature of our discussions and the decisions that we must make, it is absolutely essential that these meetings be held in closed session. To do otherwise would be a disservice to the public interest, for premature disclosure of our discussions and decisions could severely disrupt financial markets.

It is Federal Reserve policy to disclose our decisions as quickly as possible. To this there is only one exception -- the lag of 45 days in publishing the short-run targets of the

Federal Open Market Committee. The basic purpose of this lag is to deny sophisticated market watchers an opportunity to gain undue advantage over an unwary public. Apart from this delay, decisions on changes in the discount rate, on bank reserve requirements, and on stock market margin requirements, also all regulatory rulings, are announced promptly by the Board -- usually the same day that the actions are taken. Also, data on financial operations of the Federal Reserve, the conditions of member banks, the money supply, interest rates, and other financial variables, are released regularly and with great frequency. The Board submits regular and frequent reports to Congress on economic and financial matters. Indeed, the detail in which financial data are published is greater than for any other central bank in the world.

The Discussion Principles also contend that Congressional involvement in monetary policy decisions has been largely peripheral. Whatever may have been true in the past, this premise is certainly invalid today. In my experience at the Federal Reserve, Congress has never been lax in exercising its oversight of the System or in providing us with its views. Only last year, Congress revamped its oversight procedure with the adoption of House Concurrent Resolution 133, which

this Committee helped to draft. This resolution provides for four regular appearances by the Federal Reserve each year before the Banking Committees solely to discuss monetary policy. We take implementation of this resolution very seriously. I have already appeared before the Banking Committees on three occasions and expect to testify early next month before this Committee in response to that resolution. I have found that these discussions add an important dimension to the Board's deliberations on monetary policy.

In addition to these appearances, we are frequently asked to testify on a wide range of financial subjects before this and other committees of the Congress, including the newly formed Senate and House Budget Committees. Last year, for example, I testified formally before Congress on 17 separate occasions, and my colleagues on the Board appeared before Congressional committees on 23 other occasions. I also have frequent meetings with members of the Congress to discuss questions of mutual concern, and the amount of correspondence we have with members of Congress -- not simply on constituents' inquiries, but on fundamental policy issues -- is voluminous. In other words, Congressional involvement with the Federal Reserve is substantial, and is taken very seriously by the Board.

Finally, it is claimed that the operation of the Federal Reserve is "incoherent" and that its present structure fails to pinpoint responsibility for monetary policy. I believe this charge reflects unfamiliarity with the structure and operation of the System. There is no uncertainty as to the responsibility for monetary policy judgments within the Federal Reserve. It rests ultimately with the seven members of the Board of Governors. Under existing law, the Board has exclusive responsibility for changes in reserve requirements, margin requirements, and banking regulations. Changes in the discount rate originate at the Reserve Banks, but require explicit approval of the Board of Governors, and we examine every proposal for change with great care. Open-market decisions are made by the Federal Open Market Committee (FOMC), which consists of the seven members of the Board and five Reserve Bank presidents. The structure of the FOMC avoids complete centralization of monetary policy decisions in Washington, but the Board Members are plainly in the majority on that body and the Chairman of the Board serves also as Chairman of the FOMC. Thus, far from being "incoherent," the operation of the System and responsibility for decision-making within the System are clearly determined by the Federal Reserve Act itself.

A change in the basic structure of a government agency -- such as proposed in the Discussion Principles -- is justified only when some major defect has been discovered in its structure. This is not the case with the Federal Reserve. On the contrary, its structure has enabled it to serve the country well through the years, and there is no need to change it at the present time.

The Federal Reserve System, as you know, was established more than 60 years ago. If a fresh start were made, the Congress might devise a structure similar to what we now have or perhaps move in a quite different direction. Before I joined the Board of Governors in early 1970, I thought I saw all sorts of opportunities for change in the System. But I soon realized that the structure whose basic shape was devised by Woodrow Wilson, Carter Glass, and Robert Latham Owen worked quite well.

In establishing the Federal Reserve, Congress deliberately decided that the national interest required that the central bank be insulated from political pressures stemming either from the Congress or the White House. The Congress, therefore, charged the Federal Reserve with broad responsibility to protect the Nation's money and foster its effective use.

I want to turn now to certain specific suggestions that are set forth in the Discussion Principles for reorganizing the

Federal Reserve System. Two features of this reorganization plan are fundamental, and I shall devote the greater part of my remaining testimony to them.

The first of these proposed changes is to strip the Federal Reserve of all responsibilities in the area of bank regulation and supervision. Under the proposed plan, the Federal Reserve would confine its activities mainly to the sphere of monetary policy. Its regulatory functions, apart from those involving the payments mechanism, would be transferred to a new body -- the Federal Depository Institutions Commission.

In testimony before this Committee last December, Governor Holland presented the Board's position on this proposed fundamental change. It is the Board's judgment that the Federal Reserve, as the Nation's central bank, must be closely involved in the processes of bank regulation and supervision. These processes inevitably have an impact on general economic and financial conditions. If the Federal Reserve played no part in this activity, there is a danger that monetary policies and regulatory policies could be working at cross purposes. For example, since the growth of loan commitments by banks has a significant bearing on the availability of bank credit to business firms, the Federal Reserve must watch closely the movements

of these commitments. Such commitments could increase very sharply if bank supervisors paid little attention to them, and could force the Federal Reserve to pursue a more expansionary monetary policy than it would otherwise deem appropriate.

Now more than ever the Federal Reserve's role in formulating monetary policy and as lender of last resort interacts with its role as a bank supervisor and regulator. Each of these areas of public policy influences the effectiveness of the other. To separate them will weaken both.

The second fundamental change proposed by the Discussion Principles is to eliminate the separate status of the Federal Reserve Banks and to make them simply regional offices of the Board. The stock of the Federal Reserve Banks would be retired; their boards of directors would be eliminated; the presidents of the Reserve Banks would be appointed by the President, subject to Senate confirmation; and they would be paid the same salary as members of the Board of Governors. The role of the Reserve Banks in monetary policy would then be purely advisory. The Banks, in turn, would be advised by newly established advisory committees.

Retiring stock of the Federal Reserve Banks would accomplish little of practical importance. While this stock

carries certain voting rights, it limits the holder to a statutory dividend, the amount of stock a member bank must own is fixed by law, and this stock cannot be transferred or encumbered. Thus, it is by no means the equivalent of stock in a private corporation. On balance, the Board believes that ownership of Reserve Bank stock is desirable because of the incentive it provides to members to take an interest in the operations and efficiency of the System.

The other changes proposed by the Discussion Principles, would not only weaken the present machinery for developing monetary policy; they would also introduce a political dimension into the selection of Federal Reserve Bank officials. Moreover, they would curb the strong impulses within the System to improve the efficiency of the Federal Reserve Banks and to keep down their operating costs.

The 269 Reserve Bank and branch directors who now serve the System are highly qualified citizens drawn from many walks of life and all parts of the country. Some are bankers, as contemplated by law; others are industrialists, merchants, farmers, attorneys, university presidents, and professors. They are deeply interested in our country and its economic welfare. They devote a great deal of time to the System,

keeping the officials of the Reserve Banks and the Board informed on a regular, systematic basis about actual and prospective developments in their businesses, their industries, and their communities. I seriously doubt that such devotion and energy would be evoked by mere participation in advisory committees such as proposed in the Discussion Principles. Service as a director of a Federal Reserve Bank carries with it both prestige and recognition of accomplishment, and this has proved to be a significant incentive in attracting some of America's finest citizens to the Federal Reserve System. This is a resource that should not be abandoned lightly.

Moreover, many of our directors are highly experienced managers, and they have been willing to put their managerial knowledge and skills at the System's disposal. The benefits are reflected in the sharp improvement of productivity in conducting System operations. The measurable output of the Federal Reserve Banks has approximately doubled in the past eight years, with only a 40 per cent increase in System personnel. In fact, the total number of individuals employed by the System will be a little lower in 1976 than it was in 1974, despite a large increase in the measurable volume of Federal Reserve Bank operations.

The recommendations for selection and compensation of Reserve Bank presidents would, if followed, significantly diminish the interest of many of the best qualified persons for these important positions, and they would also interject transitory political considerations into the selection process. Reserve Bank presidencies are career positions within the Federal Reserve System, and the ability to offer salaries somewhat comparable to those offered by private enterprise enables us to attract highly qualified people to the Reserve Banks.

Finally, removing the Reserve Bank presidents from membership on the Federal Open Market Committee would reduce regional involvement in the shaping of our Nation's monetary policy. The Reserve Bank presidents not only bring to the FOMC a degree of experience and insight that would be lacking in a purely centralized policymaking organization, but they also are an important source of knowledge and informed opinion about regional interests and needs. There is a clear difference between an advisory role, as contemplated for the Reserve Bank presidents by the Discussion Principles, and the role of a participant sharing responsibility for policymaking. Removal of the presidents from the FOMC could have the effect

of making the Federal Reserve more introspective and less sensitive to public concerns -- a result opposite to that sought by the authors of the Discussion Principles.

Let me turn now to a matter that I mentioned earlier in my testimony -- the selection of Federal Reserve Bank directors. In view of the concern that has been expressed that the Federal Reserve is "controlled" by banking and industrial interests, let me offer a suggestion that the Board views as one way of minimizing this misinterpretation.

Under the Federal Reserve Act, six of the nine directors at each Reserve Bank are elected by the member banks. Three of these directors are typically bankers -- the Class A directors, while the other three -- Class B directors -- must at the time of their election be actively engaged in commerce, agriculture, or some other industrial pursuit in their district.

The remaining three directors -- the Class C directors -- are appointed by the Board of Governors and are considered to be the public directors. The Board appoints the chairman and deputy chairman of each Reserve Bank from among the Class C directors. In other words, as presently constituted under the law, the Reserve Bank board of directors may be viewed

as representing lenders (Class A), borrowers (Class B), and the public (Class C).

Congress may wish to consider whether responsibility for selecting Class B directors should be shifted to the Board of Governors in Washington. At the same time the Congress might wish to specify that the boards of directors encompass a broader range of interests than is required under existing law.

This would mean that a majority of the directors at each Reserve Bank would be appointed by the Board in Washington, and would represent, so to speak, the public. It would be appropriate to allow member banks to continue to elect bankers as directors, in light of the burden that member banks bear in the implementation of monetary policy and the maintenance of reserve requirements. Even here, however, there may be an opportunity for broadening the selection process. If the recommendation of the Discussion Principles for universal reserve requirements is adopted -- and the Board strongly endorses this recommendation -- the selection of Class A directors might be made by all member institutions required to maintain reserves with the Federal Reserve.

Let me now turn briefly to the remaining proposals.

The Discussion Principles recommend reduction of the number of Board Members from 7 to 5 and a reduction in their term of office from 14 to 10 years. We believe that retaining a seven-member Board not only provides for a broader range of significant skills and experience, but also helps to accomplish in an efficient way our ever-increasing workload. As to the length of term, we believe that Congress has wisely recognized that a long term for Board Members would strongly encourage independence of thought and decision. We see no reason to change that.

The Board has no basic objection to making the term of the Chairman coterminous with that of the President, but we would recommend a lag of six to twelve months between the inauguration of a new President and the expiration of the Chairman's term of office. In this way, a Chairman could be selected in a deliberative manner, apart from the political atmosphere that surrounds the selection of a new President's Cabinet. We also believe Senate confirmation of the Chairman would be appropriate.

Neither would the Board object to amending the Federal Reserve Act to make the Board explicitly responsible for helping

to achieve the objectives of the Employment Act of 1946. We already accept the Employment Act as a guiding principle. If that Act were to be amended, however, we would suggest that the Congress also expressly declare general price stability to be an objective of national economic policy. The Federal Reserve and other government agencies have interpreted the Employment Act to mean that a stable price level is an important objective of public policy, but the Act is less clear than it should be on this need. It would be useful to remove any doubts about our national commitment to a stable price level.

As to the matter of an annual economic report, we already do much of what is recommended in the Discussion Principles, and we stand ready to provide further reports that can be helpful to the Congress. However, the suggestion that the Board be required to adjust its monetary plans to the fiscal proposals of the President is seriously deficient in failing to take account of the new fiscal role of Congress under the Budget Reform Act. In addition, this suggestion runs the risk of diminishing the Board's independence by requiring the conditioning of its plans to the President's budget.

On the audit question, the Board remains opposed to an audit by the General Accounting Office for the reasons presented to the Banking Committee in earlier testimony.

In summary, we believe firmly that it is in the public interest to retain the concept of an independent monetary authority, and we oppose efforts to politicize the functioning of the Federal Reserve System. We also believe that the procedure established by House Concurrent Resolution 133 offers an excellent means for promoting a continuing discussion of monetary policy matters between Congress and the Federal Reserve. As I have noted, this procedure seems to be working well.

We see no compelling reasons to legislate fundamental changes in the Federal Reserve at this time because there is no evidence that the System has failed to function well with its present structure. However, the Board would have no objection to changing the method for selection of Class A and Class B directors and providing explicitly for a greater diversity of interests among directors. Nor would the Board object to charging the Federal Reserve with explicit responsibility to further the objectives of the Employment Act of 1946, or adjusting the term of the Chairman to conform roughly to that of the President, or requiring Senate confirmation of the Chairman.

Although the Board sees no difficulty with some of the recommendations in Title V of the Discussion Principles, we also see no clear or decisive need to adopt any of them. Indeed there are strong reasons, as I have indicated, for opposing the key premises of this Title. The world's history is littered with the economic wreckage caused by political domination of the monetary function. Your predecessors in the Congress acted wisely in providing a design for the Federal Reserve that insulated it from politics. The Board urges you not to overturn a structure that has stood so well the test of time and experience.

I would again like to commend this Committee for the thoughtful and careful approach you are taking in your continuing study of Financial Institutions and the Nation's Economy, and to indicate our desire to be as helpful as we possibly can in assisting you in your efforts.

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